IN THE

Supreme Court of the United States

October Term, 1971

No. 70-52

UNITED STATES OF AMERICA, *Petitioner*

v.

MISSISSIPPI CHEMICAL CORPORATION, ET AL.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY BRIEF FOR RESPONDENT, MISSISSIPPI CHEMICAL CORPORATION, ET AL.

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1. Respondents have relied in this case upon the proposition that when a borrower is required, as a condition to a loan, to purchase an asset from the lender for a price in excess of its fair market value, such excess is in substance interest, and is deductible as such. This proposition is, we submit, fully supported by the usury cases cited in respondents' brief and by the well-established rule of "substance over form."

Nevertheless, the government argues in its reply brief that there is no such rule of law as that contended for by respondent. In support of its argument, the government uses the illustration of a person who borrows $10,000 from a bank at 8% interest and who is required to maintain a $1,000 compensating balance in a checking account with the bank throughout the term of the loan, or is required to purchase from the bank a non-transferable, non-interest-bearing $1,000 certificate of deposit. The government argues that the borrower in this illustration is entitled to deduct only $800 per annum as interest; that he is not entitled to deduct the interest which his $1,000 might have earned over the term of the loan had he been free to invest it at the going rate of interest.

We agree, of course, with the government that the borrower in this illustration is entitled to no additional deduction by reason of the compensating balance or the certificate of deposit which he is required to maintain or to acquire. However, the obvious reason is that *in substance* the compensating balance or the certificate of deposit merely serves to reduce the amount which the borrower has borrowed. Instead of borrowing $10,000, he has, in reality, borrowed $9,000; and this is true whether the bank holds back $1,000 or whether the borrower initially receives the full $10,000, but then returns $1,000 to the bank to be placed in a non-interest-bearing account or to acquire a non-interest-bearing certificate of deposit. Accordingly, the borrower's $800 of interest represents an effective rate of 8.9% per annum on the amount borrowed, but it does not change the dollar amount of the interest paid. In other words, the compensating balance (or the certificate of deposit) in the government's illustration is nothing more than

an offset which reduces the amount loaned and which therefore increases the *rate* of interest, but which does not increase the *dollar amount* of the interest. The borrower will have had the use of only $9,000 for the term of the loan, but at the end of the term, he can be out-of-pocket no more than the $800 of stated interest.

The instant case bears no resemblance to the government's illustration. Here a sum of money was borrowed for a period of years and each time the borrower made an interest payment of $100 he was required to pay not only the $100, but also an additional $15, ostensibly for a substantially worthless share of Class "C" stock. In fact, all except a small fraction of the $15 was paid to secure the use of money and therefore should be deductible as interest. It would be pure fiction in this case to say that any part of the $15 reduced the amount of loans outstanding.

2. Respondents have pointed out that the *Lincoln* case, on which the government so heavily relies, bears no relation to the present case. *Lincoln* clearly did not involve any question of the proper allocation of a single payment between two items, whereas that is all that is involved in the present case. The parties in *Lincoln* asked this Court to decide on an all-or-nothing basis whether the taxpayer's payment into the Secondary Reserve of the FSLIC was deductible in the year paid. No question of the fair market value of Lincoln's interest in the Secondary Reserve was raised, and no evidence of value was presented.* The taxpayer con-

* In an effort to deny this, the government points to a statement in the taxpayer's brief in the *Lincoln* case that the money which it paid into the Secondary Reserve was "in truth and substance . . . gone in the year in which it is paid . . ." This is far from a contention that *Lincoln's* interest in the Secondary Reserve had a fair market value substantially less than the amount paid.

tended that the entire amount was deductible in the year paid since it was required to be paid in that year in order to secure insurance for that year, whereas the government contended that the entire payment created an asset and was therefore capital in nature. Consequently, in *Lincoln*, the only question to which this Court addressed itself was whether the payment by the taxpayer was currently deductible or was a capital expenditure. Finding that the payment served to create an asset, the Court concluded that the payment was a capital expenditure and not a deductibe expense in the year paid and that it would be deductible, if at all, only when used to satisfy obligations of the payor for insurance premiums in future years or to help pay unexpected catastrophic losses. There is certainly nothing in the *Lincoln* case to suggest that if it had been proved there, as it has been proved here, that the amount paid far exceeded the fair market value of the asset acquired, the Court would have denied the deductibility of the excess.

3. Though it maintains in its reply brief that the fair market value of Class "C" stock is immaterial (Pet. Rep. Br. 3), the government seems uneasy (as it should be) with this position. Otherwise, we submit, it would not continue its specious arguments that Class "C" stock "in substance earns a return." *Amici* demonstrated the falsity of this contention (*Amici* Br. 20 et seq.) by pointing out that the patronage dividends received by a borrowing cooperative would remain the same whether or not the cooperative sold to another cooperative all of the Class "C" stock which the transferor had been required to purchase from the Bank; and by pointing out that the patronage dividends of the transferee cooperative would not be increased one

dime as a result of the transfer to it of such Class "C" stock. The argument that Class "C" stock is an income-producing asset is pure sophistry. The fact is that *all* patronage dividends, whether attributable to the period before or after the transfer of the stock, will be paid to the transferor and transferee cooperatives, not on the basis of the Class "C" stock owned by each, but on the basis of the interest paid by each.

Respectfully submitted,

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